

VZCZCXRO1149
RR RUEHFL RUEHNP
DE RUEHMIL #0096/01 1181616
ZNR UUUUU ZZH
R 281616Z APR 09
FM AMCONSUL MILAN
TO RUEHC/SECSTATE WASHDC 1753
INFO RUEHRO/AMEMBASSY ROME 8789
RUEHFL/AMCONSUL FLORENCE 0206
RUEHNP/AMCONSUL NAPLES 0204
RUEATRS/DEPT OF TREASURY WASHDC
RHEHNSC/NSC WASHDC

UNCLAS SECTION 01 OF 02 MILAN 000096

SENSITIVE
SIPDIS

E.O. 12958: N/A

TAGS: [EFIN](#) [EINV](#) [ECON](#) [IT](#)

SUBJECT: PRIVATE EQUITY IN ITALY: GROWING, BUT IN THE RIGHT DIRECTION?

REF: MILAN 78

11. (SBU) Summary: Even in the midst of economic crisis, Italy's small private equity (PE) marketplace is expanding. Larger multinational PE firms and those in search of "mega-deals" are playing a smaller role, but local PE outfits see a potential for smaller, less-leveraged, longer-horizon, "buy and build" deals. Private equity financiers view the country's thousands of privately held small and medium companies as ripe for the picking as their traditional sources of bank credit get scarcer. On paper this rings true, but we think PE practitioners, with their war chest of eight billion euro, may be overly optimistic that these small, conservative firms will be open to private equity partnerships. Meanwhile, venture capital -- where there are plenty of start-ups looking for cash -- remains a neglected (though growing) part of the market place. End summary.

Italian Private Equity Defies European Trends

12. (U) There has been much debate over continued access to credit for the export-focused small and medium enterprises (SMEs) that dominate the northern Italian economy. Indeed the Italian government has focused many of its crisis response measures on this very issue. As noted in reftel, the global economic crisis is destroying, to varying degrees, the traditional markets of these SMEs and the talk is turning toward the need for fresh funds for companies hit particularly hard -- especially if the crisis lasts beyond 12009. Though much of the discussion has focused on the willingness or lack thereof of traditional banking partners to keep lending, the private equity (PE) sector is also presenting itself as a logical partner for these firms.

13. (U) Much like its banking sector, Italy's PE market is smaller and less-developed than others in Europe. According to 2008 data, funds collected by Italian operators amounted to only 2.2 billion euro (down from three billion in 2007, and a tiny fraction of the 69 billion euro collected in private equity funds across Europe in 2008). The Italian Association of Private Equity and Venture Capital (AIFI) also includes in its data on collections an additional 2.3 billion euro invested in the country by pan-European funds with a base in Italy. However, the PE market's small size and relative lack of exposure to risky investments, again like that of the banking sector, may be contributing to its resilience. Despite the ongoing financial crisis, Italian PE investment in 2008 was at an all-time high -- with the number of deals (372) and the value of new investments (5.5 billion euro) up significantly from 2007. According to our sources here, the 30 percent increase in the value of new PE deals in 2008 compared very favorably with France, Germany, the UK, and Spain -- all of whose PE markets saw drops of between 20 and 40 percent in 2008.

New Playing Field Suits the Locals

¶4. (U) According to practitioners, with the ongoing global economic troubles the scope of private equity deals in Italy (which are concluded predominately in and around Milan) is evolving rapidly and a distinctly Italian model of private equity could emerge. This transformation is being expedited by the end, for now, of the era of the "mega" buy-out deal which had been dominated by major international or pan-European PE players. This had been an increasingly large part of the Italian PE marketplace through 2008. Symbolic of this shift, we have in the last weeks heard of two large pan-European PE firms looking to reduce staff or up-stakes entirely from Milan. Another feature of the evolution is a lengthening time horizon, with preferred investment periods now 4-6 years rather than an average of 2 years, the norm during the 2005-07 boom time. Also shifting is the balance of equity and debt, with a prediction that new deals will be structured to include upwards of 50 percent equity investment (up from 36 percent in 2007) and debt/EBITDA ratios (already lower in Italy than on average in the rest of Europe) down from 5:1 in 2007 to below 3:1 on average.

¶5. (U) Another clear picture emerging in Italy is in the preferred type of private equity investment. About 80 percent of PE funds collected in 2008, as in the last five years, went toward buy-outs or expansions of existing firms -- the more conservative of PE ventures. Early-stage investment (seed and start-up investments) is expanding rapidly with a steady increase in both the number and value of deals in the last five years. In 2008 this segment of the market witnessed a jump of 75 percent in the amount invested.

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However, the numbers remain very low compared to the rest of Europe. Even with the near doubling of the size of the market from 2007-08, the value of such deals was still only 115 mln euro. Meanwhile, in 2007 and 2008 the number of early-stage investments remained the same (88) while the number of start-ups involved actually went down from 68 to ¶67. Also disappointing when looking at this crucial segment is the persistent reluctance of banks, country funds, and asset management funds (SGRs) to invest. In 2008 the country's tiny number of VC funds and the smattering of funds operated by city or regional governments made nearly 80 percent of early-stage investments.

Aim Small, Reduce Risk

¶6. (U) Some homegrown private equity fund managers have told us that the new reality suits them, and their narrower ambitions, just fine. One company told us that for 2009, their target was to raise around 50 million euro with which it would seek out opportunities in companies with fewer than 250 employees and sales of 50 million euro. The consensus is that within these parameters, there should be ample targets -- family-owned companies that want to grow or innovate their way out of the crisis or who are facing "succession problems" (figlio doesn't have the business savvy of padre). The increased equity stakes and longer investment horizon lend themselves to the "buy and build" focus, that, in the atmosphere of very weak IPO opportunities, seeks to build up small firms into globally competitive operations that will eventually be resold. As one private equity professional told us, PE firms could start taking the place of the local banks who for decades have been as much strategic partners as purely creditors. On the other hand, this similarity of function has made it difficult for PE firms to explain to skeptical SMEs that they offer more than the neighborhood bank.

¶7. (U) Beyond these new targets for investment, however, it seems purely Italian domestic operators will retain their reputation for caution. For instance, though a small handful of the savvier, more international firms are looking at distressed/undervalued assets as a tremendous opportunity,

the consensus for now seems to be that such comparatively risky investments are to be avoided. One senior official at AIFI said recently that in the absence of good traditional deals, Italian funds will be content to spend their time this year managing their existing portfolios of nearly 1,200 companies valued (at acquisition price) at 16.7 billion euro.

Comment: Unrequited Love?

18. (SBU) The Italian private equity sector has held its own, and there is optimism in the industry about "Italian style" PE flourishing during the tough times and into the future. We hear a consensus that, so long as the stock market is weak, and local institutional investors are solvent, reduced international attention on Italy shouldn't hurt fund inflows too much. Indeed, the sharp reduction in international flows to Italian PE, already seen in 2008, has been compensated so far by increased capital flow from domestic investors (institutional investors, family firms, and other company funds). Private equity professionals here also stress the 7.5 billion euro already in the coffers of local PE firms that are available for well-positioned investments. Unfortunately, PE firms may have trouble finding outlets for this money. While a boom in venture capital deals with the country's many cash-starved start-ups could happen, this sub-sector is still minuscule in Italy and access by entrepreneurs to such financiers remains harder than it should be. Also, it makes sense in principle that as traditional banking relations fray, SMEs with sound business models would want to seek PE expertise and financing to deal with the current crisis. However, the apparent optimism and readiness of private equity funds to get involved in existing firms is not necessarily going to be matched by a willingness on the part of privately held SMEs to accept even a modicum of outside control. Those SMEs with whom we've spoken have been uniformly unimpressed with, and even suspicious of, the idea of taking on a strange partner and are looking at all other solutions first. Unfortunately, many SMEs may not accept the notion of PE involvement until they are on their last legs; a point at which PE funds (whatever their style, philosophy, or national origin) may no longer be interested.

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